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SUBJECT: THE MEXICAN ECONOMY IN 1977 AND THE OUTLOOK
FOR 1978.

REF: MEXICO A-25

1. THIS CABLE SUMMARIZES THE KEY POINTS DEVELOPED IN OUR
A-25, DATED MARCH 9, ON THE MEXICAN ECONOMY IN 1977 AND
THE OUTLOOK FOR 1978.

2. MEXICO'S GROSS DOMESTIC PRODUCT INCREASED AN ESTIMATED
2.8 PERCENT IN 1977, LED BY A 17 PERCENT INCREASE IN PETRO-
LEUM OUTPUT AND AN 8 PERCENT INCREASE IN THE OUTPUT OF
ELECTRICITY. OUTPUT IN THE AGRARIAN SECTOR, INCLUDING
FISHING, WAS UP AN ESTIMATED 3.4 PERCENT, COMPARED TO 3.8
PERCENT DECLINE IN THE PREVIOUS YEAR. THERE IS NO DATA
YET ON THE TERTIARY SECTOR OF THE ECONOMY WHICH ACCOUNTS
FOR ABOUT 55 PERCENT OF GDP.

3. LOOKING AT GROSS DOMESTIC EXPENDITURE, IT APPEARS THAT
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CONSUMPTION OUTLAYS GREW ABOUT 3.5 PERCENT IN REAL TERMS,
THAT INVESTMENT DECLINED IN REAL TERMS, DUE TO LOWER FED-
ERAL GOVERNMENT AND PRIVATE SECTOR CAPITAL SPENDING, AND
THAT MEXICO WAS A NET SUPPLIER OF GOODS AND SERVICES TO
THE REST OF THE WORLD FOR THE FIRST TIME SINCE 1963.

4. MEXICO'S FINANCIAL SYSTEM RECOVERED FROM THE CRISIS OF

LATE 1976. DOLLARIZATION REMAINS A VERY SIGNIFICANT ASPECT OF THE MEXICAN FINANCIAL SYSTEM, BUT THE FLOW OF FUNDS INTO DOLLAR-DENOMINATED ACCOUNTS WAS REVERSED IN THE LAST FEW MONTHS OF THE YEAR. MONETARY POLICY WAS GEARED AT RESTORING CONFIDENCE IN THE PESO AND REDUCING INFLATIONARY PRESSURES GRADUALLY, BY KEEPING THE RATE OF INCREASE IN THE MONEY SUPPLY SLIGHTLY BELOW THE GDP PRICE DEFLATOR OF ROUGHLY 31 PERCENT.

5. THE DEFICIT OF THE PUBLIC SECTOR SUBJECT TO BUDGETARY CONTROL WAS BELOW THE ORIGINAL BUDGET IN SPITE OF EXPENDITURES HAVING EXCEEDED THE ORIGINAL BUDGET. TAX REVENUES IN THE ORIGINAL BUDGET WERE UNDER-ESTIMATED. REVENUES OF PUBLIC SECTOR ENTITIES ONLY SLIGHTLY EXCEEDED THE FORECAST. TOTAL FEDERAL GOVERNMENT EXPENDITURES APPEAR TO HAVE BEEN ABOUT AS BUDGETED WITH CURRENT SPENDING EXCEEDING THE ORIGINAL FIGURE AND CAPITAL SPENDING LOWER THAN PROGRAMMED. THE PUBLIC SECTOR ENTITIES' OUTLAYS EXCEEDED THE BUDGET ON BOTH CURRENT AND CAPITAL ACCOUNT.

6. THE BALANCE OF PAYMENTS CURRENT ACCOUNT DEFICIT EXCEEDED THE EARLIER FORECAST OF \$1.5 BILLION BY ABOUT \$300 MILLION DUE TO HIGHER IMPORTS THAN FORESEEN IN THE LAST FOUR MONTHS OF 1977. THE YEAR TO YEAR IMPROVEMENT IN THE CURRENT ACCOUNT WAS DUE TO AN INCREASE IN THE VALUE OF EXPORTS AND A DECREASE IN THE VALUE OF IMPORTS. A SLIGHT LIMITED OFFICIAL USE

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IMPROVEMENT IN NON-FINANCIAL SERVICE PAYMENTS WAS OFFSET BY HIGHER PAYMENTS ASSOCIATED WITH INVESTMENT.

7. THE CAPITAL ACCOUNT WAS IN SURPLUS BY \$2.5 BILLION; NET PUBLIC SECTOR BORROWING WAS \$2,950 MILLION, REPRESENTING A \$3.9 BILLION INCREASE IN LONG-TERM DEBT AND A \$950 MILLION DECLINE IN SHORT-TERM DEBT. THE PRIVATE SECTOR REDUCED ITS EXTERNAL INDEBTEDNESS. ERRORS AND OMISSIONS WERE \$212 MILLION, A SIGNIFICANT IMPROVEMENT FROM 1976 THAT APPARENTLY REFLECTS A SHARP DROP IN CAPITAL FLIGHT AND AN INCREASED LEVEL OF CONFIDENCE.

8. THE EXCHANGE RATE DEPRECIATED 14 PERCENT DURING THE COURSE OF THE YEAR IN TERMS OF PESOS PER DOLLAR, BUT THIS TOOK PLACE ON ONE DAY IN JANUARY. THE EXCHANGE RATE STABILITY DURING THE FINAL ELEVEN MONTHS OF 1977 IS VIEWED AS A KEY FACTOR IN RESTORING PRIVATE SECTOR CONFIDENCE AND IN THE RECOVERY OF THE FINANCIAL SYSTEM. THIS IMPORTANCE MAKES MONETARY AUTHORITIES VERY RELUCTANT TO LET THE RATE SLIP, THOUGH SOME ARGUE THAT SOME DEPRECIATION IS NECESSARY TO MAINTAIN COMPETITIVE PRICES FOR MEXICAN EXPORTS. IN ANY CASE, THE BANK OF MEXICO DREW DOLLARS OFF THE

EXCHANGE MARKET IN 1977, THEREBY PREVENTING AN APPRECIATION OF THE PESO.

9. THE GOM'S ECONOMIC POLICY OBJECTIVES FOR 1978 ARE A GROWTH RATE OF FIVE PERCENT, AND A REDUCTION OF THE RATE OF INFLATION, AS MEASURED BY THE CPI, TO AN AVERAGE MONTHLY RATE OF ABOUT ONE PERCENT. TO ATTAIN THE GROWTH RATE, THEY ARE RELYING ON INCREASED INVESTMENT BY THE PUBLIC SECTOR, MOSTLY FOR ENERGY, AND BY A RECOVERY OF PRIVATE SECTOR INVESTMENT. FOR THIS REASON, THE GOVERNMENT IS CAREFULLY NUTURING PRIVATE SECTOR CONFIDENCE, WHILE BEING CAREFUL NOT TO TILT TOO FAR IN PUBLIC.

10. BY ALL ACCOUNTS, ECONOMIC ACTIVITY IS INCREASING DUE LIMITED OFFICIAL USE

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TO HIGHER LEVELS OF BOTH PUBLIC AND PRIVATE INVESTMENT. THERE IS LITTLE LIKELIHOOD OF ANY DEVELOPMENTS AFFECTING THE RECOVERY DURING THE FIRST HALF OF THE YEAR AND ONE CAN BE FAIRLY OPTIMISTIC REGARDING THE SECOND HALF OF THE YEAR. SOME AREAS THAT COULD CREATE PROBLEMS, IN PART BECAUSE OF THEIR IMPACT ON PRIVATE SECTOR CONFIDENCE/INVESTMENT, IN-

CLUDE WAGE SETTLEMENTS, PRICE CHANGES, EXCHANGE RATE
CHANGES AND MONEY SUPPLY INCREASES. ADVERSE DEVELOPMENTS
IN ONE OR ALL OF THESE INTERRELATED INDICATORS COULD
AFFECT INVESTMENT FLOWS AND CAPITAL FLOWS IN THE BALANCE
OF PAYMENTS. IF SO, THE FIVE PERCENT GROWTH TARGET COULD
BE ENDANGERED AND THE GOVERNMENT MIGHT CONSIDER USING
PUBLIC SECTOR SPENDING AS A MEANS TO STIMULATE THE ECONOMY.
WHILE WE REMAIN OPTIMISTIC FOR THE SHORT-RUN, WE SHALL
WATCH DEVELOPMENTS IN THESE AREAS CLOSELY. LUCEY

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